

LETTER FROM THE | EXECUTIVE DIRECTOR



The Vice-Chair in her letter has expressed the deep sadness that all here at PERAC feel as a result of the loss of our Chairman Judge Russo. His leadership, guidance and most importantly friendship has improved not only the service the Commission provides to the people of Massachusetts but also had a lasting effect on all of us granted the privilege of working with him.

It is with a sense of gratitude for that privilege that the Commission and its staff releases this Annual Report on the Massachusetts Public Retirement Systems for 2013 a year which marked a turning point for public pension systems in Massachusetts as the investment losses suffered in 2008 have now been generally recognized and pension reforms fully implemented.

We are pleased that not only have systems weathered that storm, but most have acted to reduce return assumptions and adopt more conservative mortality assumptions, thereby enhancing preparedness for future uncertainty. In addition, it appears that the lengthy process of pension reform, which began nearly four decades ago, will slow down in the years ahead enabling the impact of major benefit revisions and corporate governance initiatives to have their intended effect.

As we have observed in the past, the willingness of retirement board members to greet major change with equanimity and cooperation puts to rest concerns about procurement practices, educational standards, and transparency that have contributed to the clamor for the destruction of Massachusetts' public pension funds and the repeal of benefits available to public employees in the Commonwealth.

PORTFOLIO VALUATION

Most investment managers charge a fee based on a percentage of the value of portfolio assets (for example a portfolio valued at \$1 million with a management fee of 1% would generate a fee of \$10,000). In the more traditional asset classes the valuation of the portfolio is clear-cut as the

holdings are publicly traded and their values are set by the market. However holdings in some asset classes are not publicly traded and as a result the manager establishes their value.

In determining the value of investments in venture capital, hedge funds and other alternative asset classes to be disclosed in financial statements partnerships often follow the American Institute of Certified Public Accountants Audit and Accounting Guide. Pursuant to that Guide all investments are to be carried at "fair value". Generally Accepted Accounting Principles (GAAP) defines "fair value" as the price that would be received in a market and sets forth a hierarchy of valuation techniques based on whether the inputs to be used are based on independent market sources (observable) or the general partners market assumptions (unobservable). Thus unlike market priced securities whose value is set forth in the newspaper each day the limited partner (retirement board) must rely on the general partner to value these types of investments.

In the event that a retirement board has allocated a relatively high percentage of its total assets to these classes the valuation of these holdings can lead to an overstatement of the rate of return of the entire portfolio.

IMPORTANCE OF TRANSPARENCY

The importance of valuation information is clearly stated in a recent New York Times article by Edward Siedle, president of Benchmark Financial Services, and former investigator with the Security and Exchange Commission's Division of Investment Management:

Nearly a quarter of all state and local public pension assets have disappeared—\$660 billion in state workers' retirement savings taken off the radar and swept into high-cost hedge, private equity, venture and real estate funds with little or no public oversight.

It appears that the lengthy process of pension reform, which began nearly four decades ago, will slow down in the years ahead enabling the impact of major benefit revisions to have their intended effect.

The profound lack of transparency related to these risky so-called alternative investments provides money managers ample opportunities to charge outlandish fees, pay politically connected middlemen (aka 'placement agents'), carry out transactions on behalf of pension investors on unfavorable terms, or even steal assets outright.

Secret alternative investments at public pensions are likely to cost public workers and taxpayers billions over the next few years.

Worse still, state pension boards have betrayed their fiduciary duties by entering into expansive agreements with Wall Street to keep the very details of their abuse of pension assets secret — including withholding information regarding grave potential violations of law.

Kickbacks, bribery, self-dealing, fraud, tax evasion and outright theft have been protected as confidential 'trade secrets' or 'proprietary business information' exempt from disclosure to the public under various state freedom of information laws.

Not surprising, the parties complicit in this secrecy strategy neglected to tell workers and other stakeholders about it. The policy itself was crafted and set in place in secrecy.

Absent reform, corruption related to secret alternative investments at public pensions is likely to cost public workers and taxpayers billions over the next few years. At stake is nothing less than the fiscal viability of state and local governments across the country, as well as government employees' retirement security.

The need for regulatory intervention by the Securities and Exchange Commission cannot be overstated. At countless public pensions around the nation, in states such as California, New Jersey, Illinois, Kentucky, Florida, South Carolina and Utah, public scrutiny of alternative investments has been stymied.

In the past year, first in Rhode Island and last month in North Carolina, state workers have investigated and identified apparent violations of law involving approximately \$100 billion in public pensions and have called on the S.E.C. to take action. Whether the S.E.C. will ignore this national crisis remains to be seen.

Absent federal intervention, state-by-state challenges to public pension secrecy schemes crafted by Wall Street will be required. It's time to put the public back into public pensions.

STAFF CHANGES

Staff changes took place during the year as PERAC Deputy Director Frank Valeri retired after an illustrious career of state service. Frank's leadership of the Audit, Disability and Return to Work Units of PERAC ensured that the Commission would conduct those responsibilities in a professional and compassionate manner. He spearheaded efforts to relieve elderly and infirm disability retirees of the need to file annual income statements, oversaw an increase in the use of technology in these efforts and implemented a number of necessary internal changes to the oversight of the audit process. Perhaps most importantly, in dealing with those he came in contact with, whether the Governor or a confused retiree filing his income statement, Frank represented the Commission with impeccable courtesy and goodwill.

In the wake of Frank's departure the Commission implemented a staffing reorganization. General Counsel John Parsons assumed the position of Deputy Director and General Counsel. John continues to provide general supervision for the Legal Unit as General Counsel but has added duties in overseeing the Disability, Audit and Section 91A/Fraud Units.

Deputy General Counsel Judith Corrigan has assumed the position of Deputy General Counsel and Managing Attorney. In that capacity Judith is responsible for direct day-to-day management of the Legal Unit as well as broader legal matters.

Rounding out the reorganization was the assignment of Derek Moitoso to Compliance Counsel where he has brought his legal knowledge and skills to bear on various compliance issues.

These personnel actions have enabled us to maintain operational continuity while reorganizing our overall approach to these functions.



EMERGING ISSUES FORUM

In September 2013, PERAC held its ninth Emerging Issues Forum at the College of the Holy Cross. Over two hundred and fifty people participated as board members attending received three educational credits. Opening remarks included a rebuttal to assertions by the Pioneer Institute regarding public pensions in Massachusetts. Misrepresentations relative to board stipends, staffing levels and transparency were highlighted. The actuarial panel, moderated by PERAC Actuary Jim Lamenzo, focused on the investment return assumption dilemma. Across the country pension funds and actuaries are grappling with the need to employ accurate assumptions while remaining cognizant of the impact of those assumptions. Bill Woollacott and Rodger Metzger of Hooker & Holcombe presented a comparison between Massachusetts and Connecticut plans by reviewing investment return assumptions and funded ratios.

All agreed that other assumptions also play a role in actuarial valuations and some, such as the salary assumption, mitigate fluctuations in the investment return assumption. PERAC Compliance Counsel Derek Moitoso chaired a session on Section 23B and a comparison with ERISA. Jeffrey Collins, Foley Hoag partner and Bill Jewitt, Ropes & Gray partner, reviewed the vendor disclosure and procurement requirements of Section 23B and suggested the best methods for board compliance.

The highlight of the event was clearly the keynote address by Senator "Mo" Cowan. As an interim appointee to fill the vacancy created by Senator John Kerry's assuming the position of Secretary of State, Senator Cowan brought a unique perspective to Washington. He shared that experience and his observations with the attendees stressing that the reality of what transpires is not always reflected in the media reports and the need to work together in meeting the challenges ahead. The Senator also discussed his compelling personal story that provides a source of inspiration and also a primer on the need to assure that hard work and personal perseverance are complimented by a caring society.

The Forum concluded with a presentation by Elizabeth Page, District Director of the Financial Industry Regulatory Authority (FINRA). Ms. Page gave an overview of FINRA's role as a regulator. She emphasized the organizations function in the area of enforcement, registration and investor education. A centerpiece of her address was a practical review of the robust tools available through FINRA for education as well as for assessing brokers and other investment service providers.

Once again an excellent program informed and educated retirement board members and administrators, actuaries, attorneys, investment professionals and other attendees.

CORPORATE GOVERNANCE

The Commission has recently set forth a requirement for investment entities doing business with retirement boards. A retirement board that seeks to invest funds with an entity that is not registered with the Securities and Exchange Commission ("SEC") or, if applicable, the Massachusetts Office of the Secretary of State ("SOS") will not receive an Acknowledgement Letter from the Commission and therefore may not make such an investment as the Commission has determined that it is in the best interest of the retirement system to withhold the Acknowledgement in circumstances in which a retirement board seeks to invest with a non-registered entity.

Another Corporate Governance initiative dealt with the posting of minutes. While minutes of PERAC meetings have always been available to any member of the interested public upon request, we have now made that information accessible online. This innovation adds to the list of transparency initiatives launched by PERAC over the past several years.

Policy makers, the retirement community, advocacy groups and the general public will now be able to review the official deliberations of the Commission with the click of a few buttons on PERAC's website.

We encourage all Massachusetts retirement boards that have not yet done so to post their minutes on their websites. This will enhance the transparency of their boards' deliberations and provide important information about the deliberations

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of the board to employees, retirees, political and administrative leaders and the general public. As PERAC moves forward with its web redesign we will explore the possibility of posting retirement board minutes on our site as well.

WEB SITE

The Commission has embarked on the process of revamping our web site. A major first step in that effort was a survey of existing users to assess areas that need improvement. Over sixty per cent of Board Administrators provided feedback. In general, comments were positive as respondents noted that they were able to find information they needed. Some suggested a better search feature and changes in the site's layout to make information easier to find. PERAC Memos, Forms & Publications and Board Profile pages were listed as the most visited while nearly half of the users indicate they are on the site about once a week.

We are now working with the Mass.gov team at the Massachusetts Information Technology Division to modify and revise the PERAC Web Site and hope to roll out a new version at the end of the year.

LEGAL ISSUES

PERAC has prevailed at the Superior Court level in the case of *PERAC v. Bettencourt*. The Court agreed with the Commission that Section 15(4) pension forfeiture may not be halted by the Eight Amendment of the US Constitution. Peabody Police Lieutenant Edward Bettencourt had been convicted of criminal offenses pertaining to his use of personal information of other police officers while on duty to access Civil Service Examination scores on the Commonwealth's Human Resources Division Website. Bettencourt challenged PERAC's instruction to the retirement board that his retirement rights were forfeit and that he was only entitled to a return of his accumulated deductions without interest. He based the

challenge on an assertion that the offenses were not related to his position and that the forfeiture of his pension would constitute an excessive fine, prohibited by the Eight Amendment. The Appeals Court rejected his job relatedness argument but returned the excessive fines issue to the District Court. The District Court found that the forfeiture is an excessive fine. The Superior Court has now overturned the District Court decision. We anticipate further proceedings in this matter.

POST-RETIREMENT EARNINGS

In addition to limits on the earnings of disabled members the law restricts the ability of retired members to receive earnings from a public employer. Post-Retirement limitations are governed by G.L. c. 32 § 91(b), which states that public retirees who return to public employment with any governmental entity in Massachusetts cannot exceed service in excess of 960 hours in a calendar year, nor can any compensation in a calendar year from a city, town, the Commonwealth, or any of its subdivisions, when added to his/her retirement allowance exceed the salary currently being paid for the position from which he/she retired. If a retiree has been retired for more than 12 months such retiree may earn an additional \$15,000 in each calendar year following such 12-month period.

In an effort to assist retirement boards and local officials in the oversight of post-retirement earnings for employees who are retired from a public retirement system in the Commonwealth, PERAC developed and disseminated the "Post-Retirement Earnings Worksheet" and "Commonly Asked Post Retirement Earnings Q & A" documents (see PERAC Memo #30.2013). It is hoped that the application of these procedures will facilitate the enforcement of this statute.

EXPERIENCE STUDY

Recently the Commission issued its third Experience Study of the State Retirement System. This report presented the results of our experience analysis for members of the State Retirement System (SRS) over the six-year period from January 1, 2006 through December 31, 2011 and is based on annual data provided to us by the SRS each year from January 1, 2006 through January 1, 2012.

The investment return assumption, which is not part of the experience analysis, has been reduced from 8.25% to 8.0% effective with the January 1, 2013 actuarial valuation. In determining the effect of the revised assumptions, we used the 8.0% investment return assumption.

We reviewed the gains and losses on plan liabilities (excluding asset gains and losses) from 2006 through 2011. PERAC performed State valuations for each year in this period. Our review of the gains and losses over this period shows that, overall, the actuarial assumptions were generally reasonable but slightly conservative. There were actuarial gains (experience better than anticipated) in 5 of the 6 years ranging from \$33 million to \$346 million. There was an actuarial loss in 2006 of \$163 million. Over the entire 6-year period, the assumptions generated a net cumulative gain of \$694 million, or an average gain of \$116 million per year. This amount is quite small considering the total actuarial accrued liability of approximately \$27.8 billion as of January 1, 2012 (average gain of less than ½ of 1% of actuarial liability each year).

As part of this experience study, we performed member reconciliations of actual retirements, terminations, and disabilities over the 6-year period. We analyzed these results using not only valuation data from each year, but also listings generated by the PERAC disability unit.

The annual funding schedule appropriation (the total plan cost) reflects two sources of plan costs and liabilities. The first is the amortization of the unfunded actuarial liability (UAL). In addition to the amortization of the UAL, the annual appropriation also reflects the normal cost (or current cost), which represents the value of benefits accruing during the coming year. The measure of the impact on the total plan cost of any change in assumptions is the impact of that change on these two components.

Overall, the revised assumptions decrease the total plan cost. This is consistent with the cumulative actuarial gains over the 6-year period.

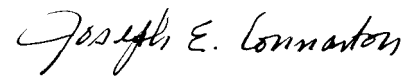
These results for the SRS reflect only one component of the Total Commonwealth Obligation. The other components are the Massachusetts Teachers' Retirement System, Boston teachers, and reimbursements to local systems to reflect COLAs granted from 1982 through 1996. The experience study of the Massachusetts Teachers' Retirement System is in progress and will be released later this year.

CONCLUSION

In our message last year it was suggested that all those involved in the Massachusetts public pension community take a deep breath and assess recent history. Having done so, we can state unequivocally that the challenges rising from the devastating collapse of the capital markets, the ensuing slowdown of the economy and recent statutory changes have been met. Everyone has worked together to keep our system intact while overcoming the fiscal strain caused by the market failure. As we emerge from that disaster, retirement boards can take great pride in having balanced the need to ensure that liabilities are addressed with the fact that state and local resources must meet a variety of needs. Responsible funding schedules are driving adequate appropriations to ultimately fully fund the system and investment returns are reverting to the pre-2008 trend with corresponding benefits to the bottom line. Professional management of assets has led to long-range returns supporting the conclusion that retirement boards have responsibly managed system assets.

There are many who keep up the drumbeat of negativism about our pension funds and those served by these funds. Let our record of fiscal prudence, compassionate administration and steady stewardship be our response.

Sincerely,



Joseph E. Connarton
Executive Director

